10 April 1973

WORKING MEMORANDUM

SUBJECT: A Note on the DOD Deflator

1.   I have been asked by the IC Staff to comment on the deflator described by the DOD (Comptroller) in The Economics of Defense Spending . . . , July 1972, Chapter 15, "Pay and Price Trends."

2.   As described, the deflator is a modified version of the Department of Commerce (BEA) deflator for Federal purchases of goods and services. The modification consists of separating out all Defense payments for pay and benefits and constructing, very precisely, a DOD deflator for pay and benefits. For all other costs, the Department of Commerce (BEA) deflator --non-Compensation component--is used.

3.   I would agree that this is more rigorous than simply to apply the aggregate Department of Commerce Deflator, because the DOD has a lower ratio of pay to expenditure than the rest of government and because its pay costs have shown significantly unique trends, as discussed in the chapter.

4.   Neither the Federal index nor the DOD index have really come to grips with two difficult issues: 1) the construction of appropriate deflators for expensive types of equipment not produced in large volume and subject to significant qualitative change over time and 2) the construction of appropriate deflators for overseas expenditures. I mention this only because the point has been glossed in Chapter 15 of the reference.

5.   The DOD approach is simpler than that followed by the AEC, which classifies its expenditures by object class and selects representative deflators for each object class. The latter approach does produce a confrontation with the kind of issue posed in the preceding paragraph.

6. What does all this signify to the problem of constructing an index for the Intelligence Community? It does suggest a shortrun procedure that would be relatively easy to institute and it also suggests a need for a more rigorous attack over the longer run.

The shortrun procedure. Ask all participating agencies to divide their budgets into 1) Pay and associated costs (Object classes 11-13) and 2) Non-Compensation costs (Object classes 21-32). Each agency should construct its own deflator for pay and associated costs, reflecting differences in the ratio between civilian and military pay and other differences in benefits. The IC Staff probably should coordinate this effort to see that common subindexes are utilized where appropriate. Then for the remaining non-pay costs, each agency should utilize the Department of Commerce (BEA) subindex for non-compensation costs. This index could be kept up to date in the IC Staff, with the cooperation of BEA.

The longrun procedure. Over the longer run, there should be research to develop deflators for overseas costs and for major equipment items relatively unique to intelligence activities (communications, major collection systems, major processing equipment).
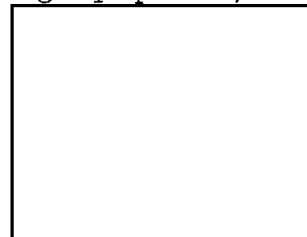
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